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A matter of high interest

Assessing how loans are reported as development aid

By Stéphanie Colin

Acknowledgements

Special thanks to the following individuals for their comments and valuable inputs: Jeroen Kwakkenbos, Jesse Griffiths and Bodo Ellmers (Eurodad); Wiert Wiertsema (BothEnds); Isabelle De Lichtervelde (ONE) and Niels Keijzers (DIE).

Thanks also to experts from the Organisation for Economic Development (OECD) Development Assistance Committee (DAC) Secretariat; the European Commission – Directorate-General for Development; the German Federal Ministry for Economic Cooperation and Development; and the Permanent Delegation of Belgium to the OECD. This report does not represent the views of these oganisations or their staff.

Vicky Anning edited the report.

Design: studio@base-eleven.com

January 2014

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Acronyms

CIRR	Commercial Interest Reference Rates
CRS	Creditor Reporting System (OECD-DAC aid database)
CSO	Civil society organisation
DAC	Development Assistance Committee, Organisation for Economic Co-operation and Development
DDR	Differentiated discount rates
EDF	European Development Fund
EIB	European Investment Bank
EU	European Union
GE	Grant element
GDP	Gross domestic product
GNI	Gross national income
G7	Group of the world's seven most industrialised economies
HIPC	Heavily Indebted Poor Countries
IADB	Inter-American Development Bank
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IMF	International Monetary Fund
LDC	Least developed country
MDB	Multilateral development bank
MDGs	Millennium Development Goals
ODA	Official development assistance
OECD	Organisation for Economic Co-operation and Development
UNCTAD	United Nations Conference on Trade and Development

Executive summary

Lending from donor governments and multilateral development banks (MDBs) to developing countries on preferential – or 'concessional' – terms has been scaled up in the past two decades. Concessional loans from MDBs accounted for $42 billion in 2011 – twice as high as in 1995 – while bilateral donors' concessional lending doubled over the past decade, reaching $16 billion in 2011.

Under specific conditions, concessional loans can be reported as official development assistance (ODA) and in turn count towards the commitment made by many donors to spend 0.7% of their gross national income (GNI) as ODA by 2015. The rules specifying the conditions under which concessional loans can be counted as aid are currently being discussed by members of the OECD Development Assistance Committee (OECD DAC). The intention of this discussion is to reform the way these loans are assessed in line with prevailing market conditions and remove the ambiguity that has allowed problematic reporting by some donors.

Using loans rather than grants to address poverty reduction is contentious among civil society organisations (CSOs). Developing countries have experienced serious debt sustainability problems in the past due to excessive lending and borrowing. Moreover, research suggests that – while grants are traditionally used to fund public services and sectors key to eradicating poverty such as education and health – loans are predominantly used in productive sectors where high economic returns are expected, and are focused on middle-income countries.

The reform of concessional lending is also taking place in a context that is incentivising donors to look for alternative sources that could be reported as ODA. For example, it is becoming increasingly unlikely that most donors will meet the 0.7% target of GNI by 2015 – given decreasing or stagnant aid budget levels. In 2012, aid from the 27 European Union (EU) countries dropped to 0.39% of the EU's GNI, its lowest level since 2007. It is expected to remain almost stagnant at about 0.43% in 2013-2014. Donors are also revisiting the ODA reporting system to capture new types of finance as development contributions, such as public leveraging of private finance, budget-neutral financial instruments and lending to middle-income countries.

This report analyses the current debate around concessional lending conditions and assesses how the rules should be refined to ensure that development objectives remain at the core of ODA reporting. More specifically, it looks at the loopholes of the quantitative and qualitative tests used to assess loan concessionality, highlights how some donors have interpreted the system's ambiguity to implement rules in a way that suits their interests, and outlines concerns of inflated donors' commitments and debt sustainability in developing countries.

This report demonstrates that the current definition of concessionality has a number of critical problems, including:

An inadequate quantitative test

The 10% reference rate used to assess the concessionality level of a loan is disconnected from real market conditions characterised by much lower interest rates. This gives rise to problematic reporting situations where loans made from market-raised funds, on which a profit could be made and which did not involve any budgetary effort, could qualify as ODA.

> Concessional loans can be reported as ODA and in turn count towards the commitment made by many donors to spend 0.7% of their GNI as ODA by 2015.

The qualitative requirement needs to be specified

Loans should be offered to developing countries at an interest rate 'below prevailing market rates' to be considered 'concessional in character'. However, this requirement lacks specification as to whether an official subsidy should be included and which numerical benchmark should be used for 'prevailing market rates'. This has allowed donors to justify loans benefiting from sovereign guarantees and the absence of charges for credit default risks as concessional and to interpret 'market rates' in the way that is most advantageous to them.

Our research further shows that current reporting rules do not provide the right incentives to donors and they inflate ODA figures:

Reporting rules lack the right incentives

All concessional loans meeting the minimum 25% grant element requirement – whether it is 26% or 99% – are treated equally in the current reporting system and the full loan amount is reported as ODA. Reporting rules should incentivise donors to offer loans with a higher degree of concessionality by counting only the concessional element as ODA.

Inflated ODA figures

Donors' commitments and actual disbursements are inflated in several ways:

1 The level of the reference rate used in the grant element calculation overvalues the grant element of the loan and therefore the corresponding value of ODA.

2 A loan with a grant element of at least 25% counts in full as ODA in ODA statistics.

3 The fact that interest repayments are not deducted from gross ODA loans inflates, in the long term, the net value of ODA resources actually transferred to recipient countries.

Scaling up and incentivising loans for development purposes raises the following concerns:

Loans with a low level of concessionality are not optimal for low-income countries

ODA delivered in the form of grants remains a crucial source of funding for public services and social sectors in the poorest countries. Given the concentration of concessional loans in middle-income countries and productive sectors with high economic returns, more loans in donors' development assistance budgets will mean less grant financing for basic social services in the world's poorest countries.

Debt sustainability concerns

As acknowledged by the International Monetary Fund (IMF), concessional borrowing has been the main driver of recent debt accumulation in poor countries benefiting from full debt relief under the HIPC (Heavily Indebted Poor Countries) Initiative. Loan repayments can undermine developing countries' future resources and, in the worst cases, can destabilise a country's economy. Grants remain a preferable form of aid in low-income countries and if concessional lending takes place, concessionality requirements should be tailored to the country's debt situation.

> The current concessionality rules are unclear, open to abuse and are not based on a clear developmental logic.

Recommendations

The discussions underway must ensure that the right incentives are in place for donors to meet their development commitments in both qualitative and quantitative terms, and that recipient countries are not adversely affected. Donors should not hide behind technical discussions as the 2015 Millennium Development Goals (MDGs) deadline approaches as a means of distracting attention away from the ultimate development objectives of the reform.

The current concessionality rules are unclear, open to abuse and are not based on a clear developmental logic. Reform is important to clarify these rules and ensure that concessional lending is only used when it can provide good developmental outcomes. It is crucial to ensure that concessionality conditions and reporting rules are revised in a way that is truly developmental and not intended to report loans more easily as ODA in the future. Both the quantitative and qualitative tests need to be refined to prevent opportunistic donor reporting with no real budgetary effort.

Eurodad makes the following recommendations, which are explained in greater detail in the last section of the report:

- **Discussions should be transparent and all stakeholders should be represented** so that both civil society and partner country governments can contribute to the discussions in order to optimise the developmental impacts of the reform.
- **Interest repayments should be deducted from net ODA** so that figures of net aid provide a genuine representation of flows to and from developing countries.
- **Only the grant element should be counted as ODA** to create the right incentives for donors to provide loans with the highest degree of concessionality and to better reflect respective donor efforts.
- **Donors should not be incentivised to deliver their aid commitments in the form of loans.** The existing DAC's recommendation that donors should reach a high average grant element in bilateral aid and deliver their aid to least developed countries in the form of grants should be turned into a requirement.
- **The 10% reference rate should be replaced with a more relevant benchmark in determining the grant element of ODA loans** so that loans provided at profit-making high interest rates are not able to pass the 25% grant element test and count as ODA, as well as to assess the concessional element of loans to its fair value.
- **Specify in the revised rules that ODA loans should include a budgetary effort in the form of an official subsidy** to qualify as ODA.
- **A debt sustainability criterion should be added** to ensure that concessionality requirements are tailored to the debt situation of borrowing countries.

Introduction

The Organisation for Economic Cooperation and Development (OECD) Development Assistance Committee (DAC) compiles aid statistics that allow comparisons and monitoring of aid volumes provided by bilateral governments and multilateral institutions for the purpose of reducing poverty in developing countries. Loans offered at preferential terms can be reported as official development assistance (ODA), provided they meet certain concessionality conditions.

The issue of concessional loans has attracted much discussion in recent years.[1] The context of tighter budgets in OECD-DAC countries is incentivising governments to find methods to increase ODA levels without budgetary implications.[2] One possible way of doing this is by reporting a larger share of their loans to developing countries as ODA. The discussion is also gaining prominence in relation to several issues on donors' agendas, including how to leverage development resources by blending public with private funds,[3] and how to capture budget-neutral financial instruments[4] and lending to middle-income countries as development finance contributions.

Lending to sub-Saharan African governments has more than doubled over five years, from $8 billion in 2006 to $20 billion in 2011.[5] Concessional lending to developing countries has followed a similar rising trend. DAC multilateral institutions have disbursed twice as many concessional loans to developing countries in 2011 ($42 billion) than in 1995 ($19 billion).[6] Similarly, concessional loans from DAC bilateral donors have doubled over the past decade, from $8 billion in 2001 to $16 billion in 2011.[7]

'Concessionality requirements' are currently being discussed within the DAC, to see whether they are relevant and how they can be improved. While concessionality addresses key issues for the future of aid quantity and quality, the debate has so far been taking place among government officials with no broad involvement of civil society and has been framed in rather technical terms.

This paper discusses the main developments in this debate over the past ten years and presents recommendations on how to optimise the developmental benefits of this reform.

The first section puts the concessionality discussion in a historical perspective, highlighting the requirements to report loans as ODA, the broader context of development finance, as well as the current state of play of the discussion. The discussion is at a critical stage as a review is underway that will specify the conditions that loans should fulfil to qualify as ODA.

The preferential terms of loans are assessed on the basis of a 10% reference rate, which is disconnected from real market conditions and allows donors to make a profit out of concessional lending.

The second section analyses the different concessionality requirements and the issues they raise. The preferential terms of loans are assessed on the basis of a 10% reference rate, which is disconnected from real market conditions and allows donors to make a profit out of concessional lending. Moreover, loans are required to be 'concessional in character' but donors' interpretations differ as to whether risk-mitigating instruments such as credit default risks and guarantees can count as a form of subsidy and about the market rates that should be used as a benchmark to measure whether loans are concessional.

The third section includes examples of how the ambiguity around the definition of concessionality requirements has led to mixed reporting by some donors, where unsubsidised loans have been reported as concessional loans and risk-mitigating instruments used to justify their concessionality.

The fourth section points out how the current reporting system of concessional loans contributes to inflating aid figures and raises concerns of debt sustainability and suitability of loans as development tool in the world's poorest countries.

The fifth section concludes with a summary of the main points and a series of recommendations for the future.

1 Origins of the debate on concessional loans

Key milestones in the history of the debate

Loans are reported as concessional if they meet several conditions stated in the definition of official development finance.[8] Loans need to be provided by an OECD member (government or multilateral institution) to a country on the list of official recipients,[9] as well as fulfilling the following requirements:

- A concessional loan should have development as its main purpose, defined by the DAC as "*the promotion of the economic development and welfare of developing countries*".

In addition, the loan needs to fulfil two specific financial conditions:

- It must include a grant element of at least 25% (referred to as the grant element test) calculated on the basis of a 10% discount rate (see explanation in Graphs 1 and 2).
- It should be 'concessional in character' – defined by the DAC as having an interest rate "*below the prevailing market rates*".

In the early 2000s, a discussion on the effectiveness of the concessionality definition took place within the DAC. In an environment of low interest rates, DAC governments could easily lend below the 10% reference rate and still satisfy the grant element test, while lending at a profitable price above their borrowing costs. In 2003 and 2004, the chair of the DAC therefore suggested setting an upper limit to the interest rates of concessional loans in an attempt to restore the effectiveness of the definition. This proposal did not reach a consensus and was rejected again when it was renewed by the chair in November 2012.[10]

The discussion disappeared for a while as interest rates rose again but came back on the agenda in 2008 when rates fell sharply due to the financial crisis. In this period, the concessionality definition was again unable to prevent mixed lending practises from donors that reported profitable loans without genuine budgetary effort as ODA (see section 3 for further details).[11] This included European Investment Bank (EIB) loans discussed in 2010 between the EU and the DAC Secretariat,[12] as well as loans from Germany and France discussed as part of their respective peer-review and the mid-term review in 2010.[13]

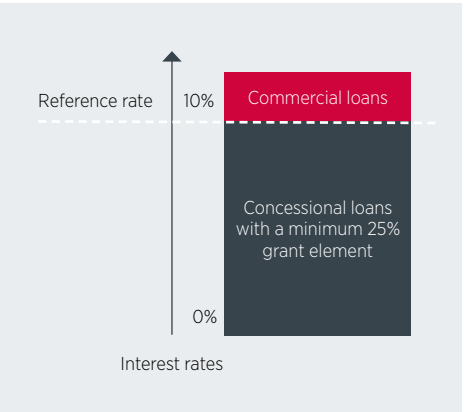
The state of play

From an initial discussion between the DAC Secretariat and a few donors (France, Germany and the EU), the debate broadened in 2012 to include all DAC members and discussions have centred on a better definition of the 'concessional in character' requirement. More specifically, members have asked the DAC Secretariat to facilitate a debate to "*establish, as soon as possible, and at the latest by 2015, a clear, quantitative definition of concessional in character, in line with prevailing market conditions*".[14]

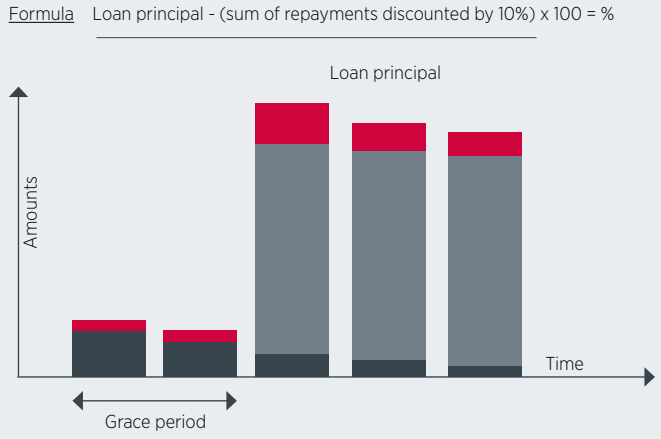
In the meantime, the three donors that spurred the debate with their reporting practices have benefited since April 2013 from a transitional compromise until the revised definition of concessionality is agreed upon by 2015. In this compromise, the DAC Secretariat has acknowledged differences of opinions across members around 'concessional in character', noted the rationale provided by the EU, France and Germany,[15] and accepted the inclusion of unsubsidised loans from these donors in ODA figures for 2011 and 2012.[16]

The temporary compromise has evoked criticism from the previous DAC Chair Richard Manning, who denounced how shocking it is "*that the OECD should publish official statistics that allow 'different practices' on such a key issue and which make a mockery of its own requirement that loans are concessional in character.*"[17]

Graph 2: Reference rate used in the grant element test



Graph 1: The grant element calculation – visualisation over time



The graph shows the repayment schedule of a fictional loan with the following characteristics: a maturity period of five years, a two-year grace period, a 3.5% interest rate and a 10% discount rate.

During the grace period, the borrower only repays loan's interest while repayments of the loan principal start in the third year. The red section corresponds to the subsidy that lowers the value of periodic repayments by 10%.

Discussions in the broader development finance context

This debate is taking place in the context of a diminishing political will among developed countries' governments to spend 0.7% of their gross national income (GNI) as development assistance to developing countries. At the EU level, the majority of governments are not on track to fulfil their aid commitments, given decreasing or stagnant aid budgets levels. In 2012, aid from the 27 European Union (EU) countries dropped to 0.39% of the EU's GNI – its lowest level since 2007. In 2013-2014, it is expected that EU aid levels will remain almost stagnant at about 0.43% of the EU's GNI.[18]

In this context, donors are increasingly looking for alternatives to grants to finance development and are turning to the private sector to bring development to developing countries.[19] In parallel, donors are revisiting the definition of ODA for the post-2015 period with a view towards broadening the measure of development finance to include resources beyond ODA, such as leveraging instruments.[20]

The ongoing review of the conditions required to report loans as ODA will have important implications for the future of ODA, both in terms of aid volumes and aid quality. It is therefore crucial that the reform creates the right incentives for poverty reduction in developing countries and that the development implications of scaling up concessional loans are carefully considered.

“ It is crucial that reform creates the right incentives for poverty reduction in developing countries and that the development implications of scaling up concessional loans are carefully considered.

2 Issues posed by the current concessionality requirements

The grant element test

Definition

To determine whether a loan is sufficiently preferential to qualify as ODA, the DAC uses a quantitative calculation called the grant element test, which measures whether a loan bears a minimum 25% grant element.

This assessment looks at the financial terms of the loan - which can be softened by its maturity, grace period and interest rate - and compares the value of repayments owed by the borrower to a benchmark of 10%. This reference rate is used in DAC statistics as an approximation of a donor's opportunity cost of lending money rather than investing it domestically (see Boxes 1 and 3 – overleaf).

More specifically, the grant element "*measures the concessionality of a loan, expressed as the percentage by which the present value of the expected stream of repayments falls short of the repayments that would have been generated at a given reference rate of interest*."[21] In other words, the grant element measures the difference between the repayments that the borrower has to make on the loan with the concessional interest rate, and the repayments that they would have had to make if the interest rate was 10% (see formula in Graph 1). The grant element percentage is therefore not referring to an actual grant share, as in the case of blending mechanisms.

Thus, the grant element is nil for a loan carrying an interest rate of 10%, it is 100% for a grant and it lies in between these two limits for a concessional loan, depending on the interest rate, maturity and grace period of the loan (see Graph 2). As shown in Table 1, this calculation values low interest rates, long maturity and grace periods. Generally speaking the DAC Secretariat estimates that "*a loan will not convey a grant element of over 25% if its maturity is less than 10 years, unless its interest rate is far below 5%*".[22]

Issues raised by the grant element test

An outdated reference rate in the current context of low interest rates:

Set at 10% in the 1970s at a time of higher market interest rates, the reference rate is no longer providing an accurate approximation of the donor's opportunity cost of lending in the environment of low market interest rates that has been prevailing since the 2000s.[23]

It is of concern that with this rate, G7 countries are able to provide loans at an interest rate of 4.75% from money initially borrowed on the bond markets at an average of 2% that would still qualify as ODA, despite the fact that a profit is made.[24]

Similarly, this has given rise to worrying situations where concessional loans have been offered at higher interest rates than 'hard loans' – commercial loans offered at market rates by multilateral institutions. For instance, in 2010 and 2011, the EU, France and Germany reported a total of $2.8 billion and $2.6 billion of ODA loans at an interest rate higher than 2.8%, the maximum rate charged by the International Bank for Reconstruction and Development (IBRD) for commercial loans to middle-income countries. More worrying still, in the case of France, three of the borrowing countries were eligible to receive funding from the International Development Association (IDA) – the World Bank fund dedicated to the poorest countries.[25]

These situations demonstrate the urgent need to find a more meaningful reference rate. Interestingly, other institutions use

Table 1: Maximum interest rates to reach a 25% grant element

	Interest rates	Maturity (in years)				
		5	10	15	20	25
Grace period (in years)	1	-0.28%	3.47%	4.84%	5.53%	5.95%
	3	2.03%	4.34%	5.33%	5.86%	6.19%
	5	3.32%	4.93%	5.68%	6.11%	6.38%
	7	n.a.	5.35%	5.95%	6.30%	6.52%

Source: European Commission calculations

Box 1: Key terms explained

The maturity period, grace period and interest rate are three ways to soften the terms of a loan.

Maturity period: number of years by which a loan is required to be paid off. DAC statistics only include loans with a maturity of over one year.

Grace period: period of time at the beginning of a loan during which the borrower only pays interest to the lender. After the grace period, the borrower starts repaying the loan principal.

Interest rate: share of the outstanding loan principal charged by the lender to cover lending costs.

Key terms used in the calculation of the grant element:

Loan principal: initial loan amount on which interest is paid.

Repayment: sums reimbursed periodically by the borrower to the lender, which are composed of reimbursement of the loan principal and interest.

Reference rate (or discount rate): the reference rate has been set by donors at 10% as an approximation of the cost of lending the money rather than investing it domestically. Donors estimate that they could have earned a 10% rate of return if they had invested the money rather than lent it. In the grant element calculation, the reference rate is used to discount the value of total repayments.

Box 2: Other grant element measurements – the case of the IMF

The IMF uses a grant element test to assess the concessionality of their loans to low-income countries under the Debt Sustainability Framework. Although this test has its own flaws and originated in a specific debt context that is not applicable to all partner countries borrowing from DAC members, it does contain two interesting features relevant to the DAC discussions:

- **A rate closer to market conditions.** The rate used to assess whether a loan is concessional better reflects market conditions at which developed countries can borrow funds, thereby providing a better estimation of the value of a donor's concessional efforts (ie grant elements). Since 11 October 2013, the IMF uses a single reference rate across countries and currencies, fixed at 5% in line with the discount rate in use for calculating the grant element of long-term US dollar-denominated loans.

  Before 11 October 2013, the IMF was using variable reference rates, across time and per currency, called the "Commercial Interest Reference Rates" (CIRRs),* which were also much lower than the 10% reference rate. For instance, for the month running from 15 September 2013 onwards, they were in the range of 1.47% to -2.50% for countries in the Euro zone and 1.70% to -3.15% for countries using US dollars, depending on the duration of the loan.

- **A requirement proportionate to debt risks in borrowing countries.** Concessional loans to a low-income country that is highly vulnerable to debt and with low public financial management capacity are requested to indicate at least a 35% grant element compared to 25% in the case of the DAC.

* minimum rates that the OECD applies to export credits lending and are updated every month by DAC governments participating in the *OECD Arrangement for Officially Supported Export Credits.*

Sources: IMF Concessionality and the Design of Debt Limits in IMF-Supported Programs in Low-Income Countries. OECD DAC explanation of concepts used in concessionality and grant element calculations, 2012. Commercial Interest Reference Rates (CIRRs), http://www.imf.org/external/np/pdr/conc/calculator; http://www.imf.org/external/np/pp/eng/2013/100413.pdf

Box 3: Different concessionality requirements – bilateral governments vs multilateral institutions

For bilateral loans, the grant element "*measures the concessionality of a loan, expressed as the percentage by which the present value of the expected stream of repayments falls short of the repayments that would have been generated at a given reference rate of interest. The reference rate is 10% in DAC statistics. This rate was selected as a proxy for the marginal efficiency of the domestic investment, i.e. as an indication of the opportunity cost to the donor of making the funds available.*"

Conversely, "*the grant element concept is not applied to the market-based lending operations of the multilateral development banks. Instead, these are classified as concessional if they include a subsidy ('soft window' operations) and non-concessional if they are unsubsidised ('hard window' operations).*"

In practice, this means that donors have to fulfill very different requirements to report loans as concessional to the DAC. Loans from multilateral institutions must be officially subsidised, either through an interest rate subsidy or a grant contribution to the core budget, while bilateral loans need to indicate a grant element of at least 25%.

Source: OECD DAC Glossary of key terms and concepts. www.oecd.org/dac/dac-glossary.htm

a reference rate in their grant element calculations that is much closer to market rates. For instance, this is the case of the IMF and the World Bank in their lending programmes to low-income countries (see Box 2). Both the methodology of variable reference rates used up to October 2013 and the new system of a single reference rate fixed at 5% provide a more realistic picture than the 10% reference rate used by the DAC. They demonstrate how ODA commitments are currently overvalued by the DAC methodology (see section 4).

The whole loan counts as ODA, not only the grant element:

In the current DAC reporting system, all loans with a grant element of at least 25% are counted as 100% ODA. As the DAC explains, "*The data record actual flows throughout the lifetime of the loans, not the grant equivalent of the loans*".[26] In practice, this means that – despite significant variations in average grant elements of loans across donors – they are all equivalent to 100% ODA in DAC statistics. In 2010 for instance, concessional loans from the French government had an average grant element of 45%, but have counted the same as loans from Japan that had a much higher average grant element of 75%.[27]

Given that the grant element represents the concessional component of a loan, donors' efforts would be more accurately reflected if only the grant equivalent of the loan was reported as ODA. The grant equivalent represents the net loss to the lender – equivalent to a grant[28] – and is measured by the difference between the value of the loan principal and the value of total discounted repayments. To measure this concessional element, the DAC could build upon the existing model used to count the ODA component of associated financing – where ODA resources are mixed with other types of financing.[29]

Taking the fictional example of a 1,000 unit loan with a 32.4% grant element,[30] this means that a grant equivalent of 323.9 units (1,000-676.1) would be reported as ODA rather than the full loan. Along the same lines, the research institute Devinit suggests using an additional aid measure called the 'gross grant equivalent' of aid, which would add up grants and grant elements of gross ODA loans.[31]

Counting only the grant element of the loan would also create a positive incentive for bilateral donors to meet the DAC recommendation of an average 86% grant

Box 4: Extracts from survey – why a stricter definition of concessional in character is needed

In 2012, the DAC Secretariat conducted a survey on DAC members' approaches to concessionality, which highlighted how they are currently implementing the concessional in character requirement.

When asked which qualitative criteria should be used to assess the concessional character of loans made from market-raised funds, the EU, Germany, France (as well as Spain, Canada, Korea and Inter-American Development Bank – IADB) did not find it acceptable to use any of the following criteria:

- the loan terms should be more favourable than the terms on which the funds were borrowed
- a subsidy has been added that results in terms softer than those on which the funds were borrowed.

These views (cf. those detailed below) are problematic as they consider that lending at a higher interest rate than one's borrowing costs and with no budgetary effort is compatible with the idea of concessionality. In practice, such loans follow a commercial logic as a profit is being made.

France's view on loans made from market-raised funds:

"*Conditions that determine whether a loan is concessional, or not, do not rely on the sources of the funding (loan from the capital market or government revenue, or from a blending of both…) and at what cost the lender himself has raised these funds from the market.*"

Germany's view on loans made from market-raised funds:

"*We consider loans to be concessional if they are offered to the borrower at a lower rate than the borrower would normally pay on the capital markets. It does not matter how the lower rate is attained (e.g. through direct or indirect subsidies) and at what cost the lender himself has raised these funds from the market.*"

Source: OECD DAC Results of the survey of approaches to determining concessionality of loans (Text emphasis added by the author).

element in bilateral ODA commitments (see section 4). Valuing loans differently in proportion to their concessionality levels would also make sense, because the higher the grant element of a loan, the closer its value is to a cash grant equivalent – i.e. a grant of similar size.

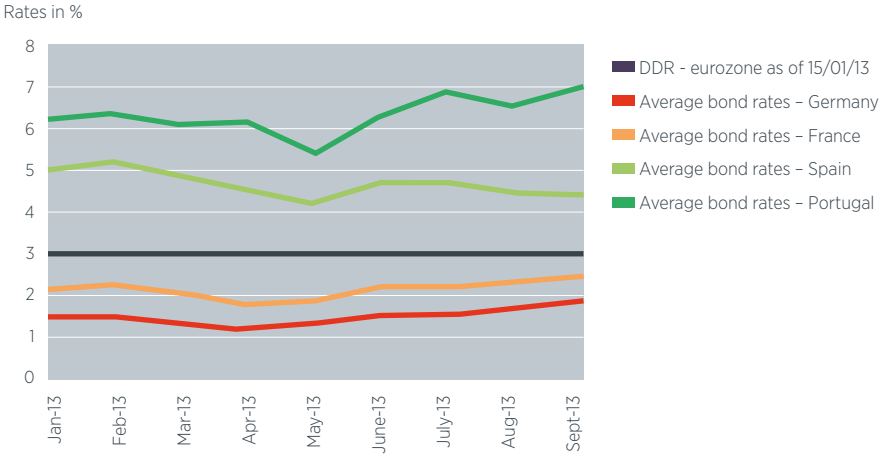
Ambiguity around the 'concessional in character' requirement

Definition of the requirement

The 25% grant element is a quantitative test that assesses the concessionality of a loan on the basis of its financial terms. As explained, in the current low interest rates environment donors can easily meet this condition with loans made from funds borrowed on capital markets where no government subsidy has been added. Whether a loan counts as ODA therefore largely depends on the second qualitative test that assesses the concessional character of a loan.[32]

This requirement is currently too broadly defined as '*below market interest rates*'[33] making it unclear what type of donor effort is required, what market rate is referred to, and whether 'below market rates' means simply 'below' or 'significantly below'. This lack of specification currently allows donors to interpret the requirement in a way that suits their interests, as highlighted by the survey of the DAC Secretariat from 2012 (see Box 4).[34]

Graph 3: Differentiated discount rate (DDR) compared to average bond rates



Source: European Central Bank, Long-term interest rates statistics for EU member states

> In the current DAC reporting system, all loans with a grant element of at least 25% are counted as 100% ODA.

Issues posed by unspecified requirement

First, the DAC Secretariat and DAC members have not come to an agreement on whether a minimum donor effort is required to make a loan concessional in character. In this discussion, the DAC Secretariat considers that loans made from market-raised funds should include an 'element of official sector subsidy' (ie, grant) to be reported as ODA. Donor effort is at the core of ODA and the corresponding 0.7% target used to monitor donor performance. As grants represent a 100% budgetary effort, concessional loans should also include a budgetary effort to qualify as ODA and donors should not earn money from lending to developing countries.

The donor effort component is also rendered ambiguous by the fact that concessionality requirements are different for multilateral institutions and bilateral donors. Loans from multilateral development banks are not subject to the grant element test. Instead their loans are required to include an official subsidy (see Box 3). Some donors have interpreted this different treatment in a manner that suits their interests (see the case of EIB loans in section 3).

In addition, there is a debate underway among DAC members about whether public guarantees supporting loans should be considered as an implicit subsidy counting as donor effort, thereby justifying the concessional character of guaranteed loans. It is crucial to refine the current rules as, in the meantime, some donors – such as the EU, France and Germany – have been reporting guaranteed loans as ODA (see section 3 for further details).

Secondly it is not clear in practice whether 'below market rates' should be interpreted from the point of view of the recipient or the lender. In the first case, a loan is concessional if it costs less to the recipient than alternative financing available on capital markets. In the second case, a loan is concessional if it offers more favourable terms to the borrowing country than the terms on which the funds were initially raised. The DAC survey shows that this second interpretation, which would prevent profit-making loans, is currently being opposed by some donors (see survey extracts in Box 4).[35] Such interpretation would prevent them from borrowing funds on capital markets at an average of 2% (average bond markets rates) and relending them to developing countries at around 4.75% in the form of concessional loans.[36]

Finally, there is currently no agreed benchmark for 'below prevailing market rates'. According to suggestions made several times by the DAC chair, concessional interest rates should be 25% lower than the interest rates used to measure the concessionality of tied aid and export credits (called the differentiated discount rates (DDR) – see Box 5). This absence of consensus is problematic. In the meantime, most DAC loan-giving donors are currently using the DDR as a benchmark. On average 2% higher than government bond rates, which allows them to make a 'gross profit' of 2% while still counting these loans as ODA (see Box 5 and Graph 3).

Box 5: Proposals for capping ODA loans interest rates at 75% of the DDR

In 2003-2004 and 2012, the serving DAC Chairs, Richard Manning and Brian Atwood, suggested setting an upper limit for the interest rate of ODA loans. The proposals were calling for an interest rate not higher than 75% of the differentiated discount rate (DDR), the reference rate – updated on a yearly basis – used to calculate the concessionality of export loans under the OECD Agreement on Officially Supported Export Credits.

Given the lack of transparency in the DAC voting system, it is not possible to understand why the proposals did not reach the required consensus and how many DAC members were in favour or against. Some possible explanations are:

- **Fear of losing control over the reference rate?** Only nine donors out of 27 DAC members who participate in the OECD *Arrangement on Officially Supported Export Credits* have control over setting DDR rates while this is not the case for the remaining DAC members. Those nine countries include Australia, Canada, the EU, Japan, Korea, New Zealand, Norway, Switzerland and the US.
- … or that **'DDR minus 25%' proposal would have made lending less profitable?** As highlighted in the DAC Secretariat survey, DAC members who reported significant amounts of ODA loans in recent years, including France and Germany, have preferred to use the DDRs as a benchmark (as opposed to the DDR minus 25% discussed above). This has allowed them to make a 'gross profit' of 2% while still counting these loans as ODA because DDRs are roughly 2% above the government bond rates at which donors can raise funds for lending (see Graph 3).

Although the 'DDR minus 25%' proposal did not reach an agreement, it demonstrates the urgent need to revise the current methodology by specifying the numerical benchmark that determines whether a loan is 'concessional in character'.

Sources: OECD DAC Explanation of concepts, p.3 and Loan concessionality in DAC statistics, p.6, Minimum interest rates, Benchmarking concessionality in character, p.6.

> Whether a loan counts as ODA largely depends on the second qualitative test that assesses the concessional character of a loan.

3 Mixed reporting by donors allowed by the system's ambiguity

The combination of low interest rates and unspecified 'concessional in character' requirements has led to mixed reporting situations by some donors. These practices highlight the urgent need to define 'concessional in character' in a way that would require a real budgetary effort from donors and alignment with development objectives. In addition, as grant financing remains the reference for donor effort, donors need to prove the development additionality of financing poverty reduction through loans supported by risk-mitigating instruments.

The ambiguity has allowed donors to report unsubsidised loans as ODA

In 2009, EIB loans spurred a discussion between the DAC Secretariat and the EU on whether loans made from market-based funds should include a budgetary effort to be 'concessional in character'. According to the DAC Secretariat, loans such as those of the EIB in 2008 made from funds "*raised on capital markets and re-lent at harder terms*"[37] should not be counted as ODA when they do not specify whether they include an official subsidy.[38]

The EU disagreed with this interpretation, arguing that EIB loans were 'concessional in character' as interest rates were below DDR rates and loans included a budgetary effort given that the public guarantee supporting the loans was included in the EU budget.[39]

In this disagreement, the EU also asked to be treated as a bilateral donor, meaning that EIB loans would not require an official subsidy. Last June, the EU's claim was granted so that the EU is now treated as a bilateral donor for the purpose of DAC reporting.[40]

As explained previously (Box 5), DDR rates do not represent a meaningful reference for market rates as they are currently on average 2% higher than the bond rates at which donors can borrow funds.

Donors have been using risk-mitigating mechanisms to justify ODA loans

In 2010, the DAC peer review of German aid and the mid-term review of French aid raised the issue of whether the use of instruments such as credit default risks and public guarantees to support loans should count as a form of budgetary effort making a loan 'concessional in character'. According to France and Germany, such instruments are implicit subsidies – as opposed to an explicit subsidy in the form of a grant – which lower the cost of the loan to partner countries.[41]

This interpretation is problematic because counting public guarantees and the absence of remuneration for credit default risks in concessionality assessments would lead to double-reporting.[42] The current system already gives credit to donors for taking risks through debt-forgiveness. In case risks materialise when the borrower defaults, donors can forgive the debt to the borrower and record the defaulted loans as ODA. Similarly, in the current DAC reporting, public guarantees are recorded when they are activated in case the borrower defaults on the loan.

Under the current compromise, the DAC temporarily accepted the views of France and Germany, while stating that, for other members, "*the practice of ODA reporting remains that loans made from market-raised funds should only be reported as concessional if they have an element of official sector subsidy*".[43] Applying different reporting requirements to DAC members risks creating a dangerous domino effect that incentivises other bilateral donors to report market-based loans (ie, hard loans) as ODA and inflate ODA volumes substantially (see section 4). Moreover, this compromise is fundamentally unfair to other donors that are attempting to fulfil aid commitments with real fiscal contributions.

4 Inflated aid figures and serious aid quality concerns

How the reporting system is inflating aid

Aid inflated by the current grant element calculation

The grant element calculation used by the DAC to assess loans' concessionality inflates aid volumes in the short term in two ways. First, loans with at least a 25% grant element count in full as ODA in DAC statistics, whereas the actual concessional share of a loan consists of the grant element only. This is inflating the value of ODA loans and in turn donors' ODA commitments and highlights the need to report loans in a more accurate manner by recording only the grant equivalent of the loan as ODA[44] (see section 2).

Secondly, the 10% reference rate overvalues grant elements, making more loans eligible as ODA. Using a lower reference rate such as the IMF's rates used up to October 2013 shows that grant elements of major loan-giving donors would be significantly lower – 50% less in the case of France, Germany and Japan and 36% less in the case of Spain. As shown in Graph 4, Japan gave an average grant element of $3.1 billion under the IMF criteria as opposed to $6.2 billion under the DAC criteria. Similarly, France and Germany each committed about $1 billion in 2010 under the DAC criteria compared to $504 million and $603 million respectively under the IMF criteria.

Finally, unless the ambiguity around the official subsidy requirement is quickly clarified, donors will have an incentive to report unsubsidised loans as ODA. This could potentially inflate aid volumes as a significant share of these loans, whose amounts are in the range of $50 billion and $20 billion per year for multilateral institutions and bilateral donors respectively, could be reported as ODA.[45]

Aid inflated by interest repayments

Concessional loans are theoretically ODA-neutral: the value of ODA loans is 0 over the course of a loan, as repayments count as negative flows on the initial loan amounts disbursed. By capturing these repayments, net ODA figures give an estimate of actual aid resources transferred to developing countries. However, the current net ODA loan figures are inflated by interest repayments that are not deducted from gross ODA loans (see fictional example in Graph 5).

If interest repayments – where data is available to the DAC – were included, they would count as a negative flow that would lower the value of net ODA loans and total ODA. Interest repayments from ODA loans made by EU member states and EU institutions totalled €590 million in 2012 with 91% of this amount coming from three donors: EU institutions (€248 million), Germany (€174 million) and France (€120 million).[46] Similarly, net global ODA would have been $5 billion lower if interest repayments had been included in net ODA loans figures.[47]

Aid quality concerns

Key qualitative considerations should be taken into account in the current debate:

ODA grants are crucial to least developed countries

ODA represents a significant share of low-income countries' resources to finance the provision of public services and social sectors in aid of the poorest communities. In 2011, ODA accounted on average for 10% of low-income countries' GDP and this share has remained constant over the past ten years.[48]

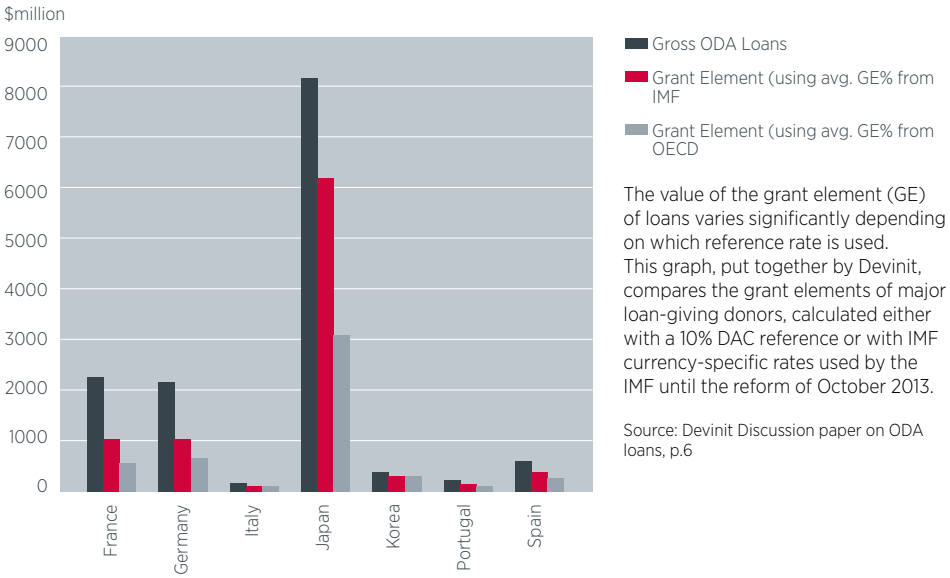
Research confirms that grants are, from the point of view of recipient countries, more appropriate to target the poorest. First, loans are concentrated in middle-income countries. In 2011, 85% of concessional loans from DAC countries went to middle-income countries, totalling $23 billion compared to $5.8 billion to low-income countries.[49]

Secondly, loans are skewed towards productive sectors with economic returns.[50] In 2011, almost half of ODA loans from DAC countries (48.6%) have been used to finance productive sectors, whereas only about a third (29.75%) went to social sectors.[51]

In line with this, the United Nations Conference on Trade and Development (UNCTAD) responsible lending and borrowing principles advise borrowers to contract a government loan only if the expected social return is higher than the interest rate.[52] However, the financial value of most actions in the area of poverty eradication and the provision of essential services is abstract and difficult to calculate despite their social return in the long term. The UN has therefore stressed repeatedly that more grants are needed if poor countries are to reach the Millennium Development Goals (MDGs) and other internationally agreed development goals.

Given the sectoral and country concentration of loans, the scaling up of concessional loans would not benefit low-income countries and would deprive them of essential grant financing. Recently, the DAC peer review of French aid concluded that the growing share of loans has been associated with a corresponding "*decrease of grants [which] reduces possibilities for bilateral co-operation in some sectors (basic social services,*

Graph 4: A reference rate that overvalues the grant element of loans



The value of the grant element (GE) of loans varies significantly depending on which reference rate is used. This graph, put together by Devinit, compares the grant elements of major loan-giving donors, calculated either with a 10% DAC reference or with IMF currency-specific rates used by the IMF until the reform of October 2013.

Source: Devinit Discussion paper on ODA loans, p.6

governance) and contexts (fragile states and certain LDCs) […]".[53]

Since the mid-1970s, the DAC has "*recognised the special value of grant assistance*" and recommended that bilateral donors' overall ODA commitments should indicate a minimum 86% grant element (see Box 6). The larger the share of ODA loans in a donor's commitments, the more difficult it will be for this donor to fulfil the DAC recommendation. The DAC estimates that a donor that delivers half of its aid in the form of concessional loans can only fulfil the DAC recommendation if the average grant element of its ODA loans is at least 72%.[54] In 2010, major loan-giving donors such as France and Germany had an average grant element in their bilateral loans of less than 50% (45% and 49% respectively).[55]

Incentives to fulfil this objective should be strengthened as this is currently only a recommendation. Turning the DAC recommendation into a requirement would incentivise donors to maintain a balance between loans and grants and continue targeting ODA resources to countries where it is most needed.

Box 6: The DAC recommends at least 86% grant element

Recommendation for all developing countries

"In order to achieve a further softening of overall financial terms of ODA, Members should endeavour fully to maintain or achieve as soon as possible an average grant element in their ODA commitments of at least 86 per cent. In this connection the special value of grant assistance is recognized."

Specific recommendation for least-developed countries

"Official Development Assistance to these countries should be essentially in the form of grants, and as a minimum, the average grant element of all commitments for a given donor should either be at least 86% to each least-developed country or this objective over a period of three years, or at least 90% annually for the least-developed countries as a whole."

This recommendation means that 86% of bilateral development cooperation should take place in the form of grants/grant equivalent. In the case of poorest developing countries, bilateral development cooperation should mainly be done through grants.

Source: OECD-DAC. (1978). Recommendation on Terms and Conditions of Aid, http://www.oecd.org/dac/stats/31426776.pdf

Loans pose serious debt sustainability risks if not used with caution

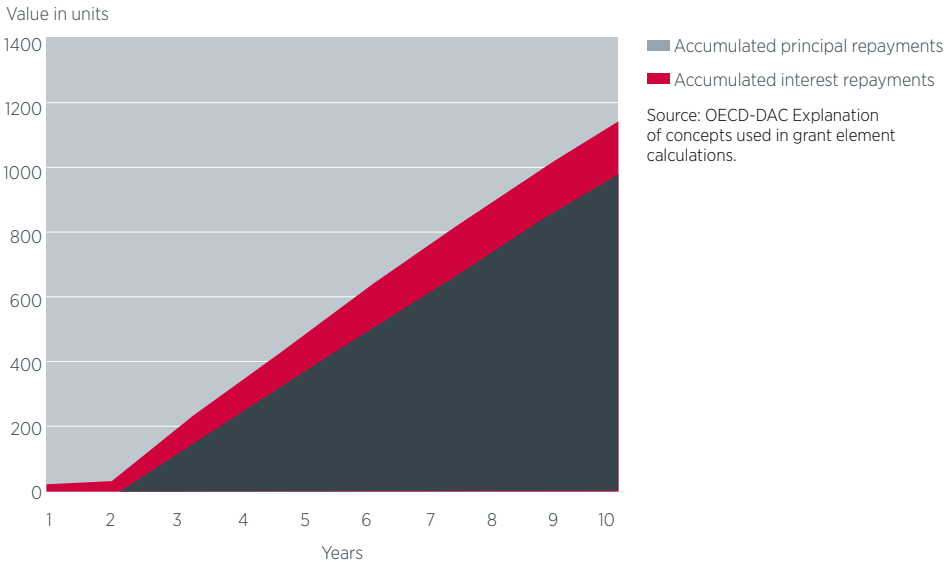
Low-income countries have a low tolerance for debt, and loans can generate significant debt sustainability risks if they are not carefully managed. Loan repayments generate significant reverse flows – only partly counted in the DAC system – that can undermine developing countries' future resources and, in the worst cases, can destabilise a country's economy.[56]

Lessons need to be drawn from the past on how careless lending and borrowing has caused numerous debt crises in developing countries since the 1980s. The new trend of moving away from grants to (concessional) loans threatens the successes made by debt relief initiatives over the past decade that brought most developing country debts down to sustainable levels. A recent IMF paper reports, "*In countries that reached the completion point under the [heavily indebted poor countries] HIPC Initiative several years ago, concessional borrowing has been the main driver of recent debt accumulation.*"[57]

The fact that the DAC concessionality requirements are uniform irrespective of the borrowing country's environment is therefore problematic. Any revision to concessionality rules should add a debt sustainability criterion to ensure that donors are disincentivised to lend to countries with high debt risks. As such, lessons could be drawn from the IMF concessionality requirements, which are tailored to the country's debt situation and therefore set at 35% minimum for low-income countries that are highly vulnerable to debt and with low public financial management capacity[58].

There is an urgent need to strengthen these incentives as research has shown that existing initiatives such as the Debt Sustainability Framework at the multilateral level are not respected by donors. In 2011 for instance, the IMF lent $900 million to countries rated at high risk of debt distress or in debt distress. In nine of these countries, loans accounted for 10% of their ODA.[59] Similarly, some bilateral governments are not factoring debt risks in their lending decisions, such as the UK – which lent to Grenada, a country at high risk of debt distress.[60]

Graph 5: A fictional example of loan repayments over time



Source: OECD-DAC Explanation of concepts used in grant element calculations.

Conclusion and recommendations

The ongoing review of the conditions to report loans as ODA provides an opportunity to refine the rules and ensure that these forms of finance achieve developmental goals. This report has outlined how weaknesses in both the quantitative and qualitative tests used to assess whether loans are concessional are not fit for this purpose. This results in a distorted picture of donors' efforts, which risks undermining the credibility of the reporting system.

The context of budget cuts across Europe, combined with the ambiguity of the DAC system, has given rise to mixed reporting by donors that are trying to meet their aid commitments without using up too much of their budgets. Civil society therefore needs to remain watchful and ensure that aid quality is not undermined by technical discussions on ODA reporting.

Scaling up concessional loans raises concerns that the poor will be short-changed if the new rules do not incentivise donors to provide fresh grant money or consider the debt sustainability implications of concessional lending more carefully.

Eurodad offers the following recommendations to ensure that future concessionality rules create the adequate developmental incentives:

As a general principle, we recommend that:

Discussions should be transparent and all stakeholders should be represented

The debate should include all stakeholders. To date (6 November 2013), CSOs and partner country governments have not been able to actively participate in the meetings of the Working Party on Development Finance Statistics. With their critical approach, civil society can optimise the developmental impacts of any reforms. Information should be made available to the general public as soon as decisions have been made or discussions have taken place. We welcome recent efforts to involve civil society and developing country governments in the discussions.

Our key recommendations are:

Deduct interest repayments from net ODA

Actual amounts of ODA transferred to developing countries are inflated by interest on loans. In 2012, developing countries repaid €590 million of interest to EU institutions and governments that were counted as ODA. Interest repayments should be deducted from ODA figures for net ODA to provide a genuine representation of flows reaching developing countries.

Count only the grant element as ODA

Donors should be incentivised to provide loans with the highest degree of concessionality and rewarded for their higher donor effort. Only the concessional component of a loan represented by the grant element should be reported as ODA. The DAC can build on the existing methodology for associated financing where ODA is mixed with other types of financing but only the concessional element is counted as ODA.

Donors should not be incentivised to deliver their aid commitments in the form of loans

The DAC's recommendation to reach an average grant element of 86% in bilateral aid commitments and to deliver their aid to least developed countries essentially in the form of grants should be turned into a requirement. This requirement would incentivise donors to maintain an appropriate balance between grants and loans, and continue to use grant financing in countries where it is most needed.

In addition, we recommend:

Replacing the 10% reference rate with a more relevant benchmark in determining the grant element of ODA loans

Assessing a donor's opportunity costs on the basis of a 10% reference rate created in the 1970s is inappropriate. From 2008 to the present, this inflated rate has allowed loans provided at higher interest rates than commercial loans from multilateral institutions, and on which a profit could be made, to pass the 25% grant element test and count as ODA. This rate also overvalues the concessional element of loans. With a lower rate, such as that used by the IMF, the grant element would be significantly lower: 50% lower than the reported $1 billion in the case of loans made by France and Germany in 2010. To prevent such problematic reporting from happening, the new benchmark should be better aligned with interest rates at which donors can borrow their funds. The DAC could draw lessons from the system used by the IMF and agree with its stakeholders on the most appropriate rate.

Specify in the revised rules that ODA loans should include a budgetary effort in the form of an official subsidy

As grants represent a 100% budgetary effort from donors, concessional loans should also include a budgetary effort to qualify as ODA. The concessional in character requirement should specify this explicitly to prevent donors from re-lending "at higher rates" money that was initially borrowed on the markets without adding an official subsidy and still count these loans as ODA.

Add a debt sustainability criterion

Concessional loans should be used with the greatest caution as they threaten to reverse the sustainable levels of debt achieved in most developing countries. Concessionality requirements should not be uniform but should be tailored to the debt situation of borrowing countries. The DAC can build on the IMF system of higher concessionality for low-income countries at risk of debt distress (ie, 35% grant element) but should tighten them further by only allowing loans with high concessionality levels.

> In 2012, developing countries repaid €590 million of interest to EU institutions and governments that were counted as ODA.

Annex

Methodology

This research has mainly been desk-based and consisted of analysing relevant public documents from the OECD-DAC, including from the Working Party on Development Finance Statistics, the Credit Reporting System, peer reviews, as well as from bilateral donors and CSOs/research institutes.

The findings of this report are based on information contained in declassified documents available to the public at the time of writing. Any perception of missing or outdated factual information cannot be attributed to the author where records from meetings or discussions have not been made public.

To complement desk-based research, an informal reference group was established with relevant experts from the donor, civil society and research community. Consultations with these experts and feedback into various stages of the research have allowed the clarification of information.

Raw and processed data in this report have been obtained from OECD-DAC declassified documents, the OECD Credit Reporting System database and research carried out by the research institute Devinit.

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- synthesise and exchange NGO and official information and intelligence
- facilitate meetings and processes which improve concerted advocacy action by NGOs across Europe and in the South.

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www.eurodad.org

Contact

Eurodad
Rue d'Edimbourg 18-26
1050 Brussels
Belgium
Tel: +32 (0) 2 894 4640
www.eurodad.org

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